92-SBE-006

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 91R-0505-MW
BRIAN L. AND PHYLLIS HARVEY	)	

Appearances:

For Appellant: Robert A. Briskin
Attorney at Law

For Respondent: Karen D. Smith
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a),[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Brian L. and Phyllis Harvey for refund of personal income tax in the amount of $3,113,576.31 for the year 1986.

[1/] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

The question presented by this appeal is whether appellants were entitled to exclude from preference income, pursuant to former section 17063.11,[2/] the unrecognized portion of the capital gain from the sale of small business stock.

Mr. Harvey (hereinafter referred to as "appellant") founded Alflex Corporation (Alflex) and acquired stock in the corporation in 1968. In 1986, appellant sold his Alflex stock and, on his return for that year, included 50 percent of the gain from the sale pursuant to former section 18162.5,[3/] subdivision (a). Since the Alflex stock met the definition of "small business stock" found in subdivision (e) of section 18162.5, he excluded the unrecognized portion of the gain from preference income pursuant to section 17063.11. The return was audited by the Franchise Tax Board (FTB) and, on January 9, 1991, a letter was issued saying that the audit had resulted in no change in appellant's tax liability. The letter went on to say that the examination would not be reopened unless the FTB received "new information having a material effect on [appellant's] tax liability . . . ." Appellant then received a Notice of Proposed Additional Tax (NPA) dated March 21, 1991, which disallowed appellant's use of section 17063.11 and included the unrecognized portion of appellant's capital gain in preference income. Appellant paid the resulting assessment and interest and filed a claim for refund.

The appellant objects first to the issuance of an NPA after he had received a "no change" letter, when there had been no new information, such as a federal determination, on which to base the reopening of the year. The FTB states that it issued the NPA following the "no change" letter because of "new information," namely, its determination that this board's decision in the Appeal of Magnus F. and Denise Hagen, decided April 9, 1986 (rehearing [requested by FTB] denied, July 29, 1986), was in error and "would be considered and held invalid in several court cases now pending before the California courts," in which case the appellants would not be allowed to exclude from preference income any of the gain from their sale of the Alflex stock. (Resp. Br. at 2.) It also contends that it is not limited in the number of times it may examine a return for a given year. The appellant points out, in reply, that the court cases presumably referred to by the FTB are all simply superior court cases and the Hagen issue was argued in only one of them.

The substantive issue raised by the FTB is its request that our board reconsider and overturn the decision in the Appeal of Magnus F. and Denise Hagen, supra. In that appeal, our board

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[2/] This section was repealed by AB 53 (Stats, 1987, ch. 1138), operative for taxable years beginning on or after January 1, 1987.

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held that the preference income exclusion provided by section 17063.11 for small business stock was applicable regardless of the date of acquisition of the small business stock. The FTB had argued that section 17063.11 should only apply to small business stock acquired after September 16, 1981. It took this restrictive date from subdivision (d) of section 18162.5. Section 18162.5 provided rules for determining the amount of capital gain to be included in income for sales of both small business stock and non-small business stock. It also included a definition of small business stock. (Rev. & Tax. Code § 18162.5, subd. (e).) The restriction as to acquisition date found in subdivision (d) applied, by its terms, only to subdivision (b) of section 18162.5, dealing with the amount of capital gain from the sale of small business stock which was includable in income. Our board's decision concluded that the restrictive date in 18162.5, subdivision (d), was specifically limited to the application of subdivision (b) of section 18162.5 and that section 17063.11 had no such restriction, only a specific operative date for taxable years beginning on or after January 1, 1982.

FTB is now arguing that the decision in Hagen was erroneous because of a "previously unidentified statutory ambiguity which would permit appellant to 'have its cake and eat it too.'" (Resp. Br. at 4-5.) It states that appellant here has used the non-small-business-stock provisions of section 18162.5, subdivision (a), to compute its taxable capital gains from the subject transaction and now attempts to exclude the same gain from preference income as well by treating it as if it were small business stock, as defined in subdivision (e) of section 18162.5. FTB argues that the restriction of section 18162.5, subdivision (d), must be applied to section 17063.11 to prevent this inconsistent and unintended result. The appellant argues that this board should continue to follow the decision in Hagen, as it has done in at least two other cases since then. (See Appeal of Henry J. and Florence Bradley, 89-SBE-024, Sept. 26, 1989; Appeals of Bing M. and Irene Leong, and Shirley J. Leong, 88-SBE-025, Oct. 18, 1988.) He also points out that the Legislature has not seen fit to modify section 17063.11 to change the result reached in Hagen.

We find the FTB's belated discovery of a "statutory ambiguity" and the cure for it, which FTB insists is the only way to solve the problem, to be unpersuasive and disingenuous. For six years, taxpayers, and, until very recently, the FTB, have relied upon and followed our decision in Hagen. This, by itself, is strong incentive not to retroactively impose a different rule on taxpayers. The FTB's argument that the taxpayer should not be able to have his cake and eat it, too, while perhaps appropriate for the agency given the job of administering the income tax and, at least in some sense, of protecting the fisc, is effective neither as a legal nor a policy argument before this board. Our duty is to determine the taxpayer's correct tax liability in accordance with the law. In so doing, we publish opinions that taxpayers and the FTB rely on as precedent. While there have been instances when we have overturned our earlier decisions in some cases in light of changing conditions or appropriate new legal arguments, this has happened no more than perhaps four or five times since this board's first decision was published in 1930. Therefore, we would need some fairly compelling reason to overturn our decision in Hagen. The FTB has not provided one.

The FTB's argument here is merely a variation or refinement of the argument that it made, and we rejected, six years ago in Hagen. We said in that case that the language of the statute was clear and unambiguous and we decided the case based on the plain meaning of the statute. The

FTB now insists that there is an ambiguity in the statute, since the taxpayer may be able to take advantage of two favorable statutes instead of just one. This, however, is not due to an ambiguity in section 17063.11, but to an apparent inconsistency between section 17063.11 and section 18162.5 arising from the way the statutes were drafted. While we agree that the inconsistency in these sections needs to be resolved, it is neither necessary nor desirable to limit our search for a solution to that proposed by the FTB. We see no new reason to superimpose the restrictive date of subdivision (d) of section 18162.5 on the operation of section 17063.11. Therefore, we hereby reaffirm our previous decision in the Hagen appeal.

FTB also argues, in the alternative, that if our board follows the decision in Hagen, appellant will still not be entitled to a refund since no capital gains exclusion provisions would apply to the gain in the first place: subdivision (a) of section 18162.5 does not apply to small business stock, and subdivision (b) of that section applies only to small business stock.

With regard to the FTB's alternative argument, appellant argues that the FTB should be estopped from asserting the argument because appellant detrimentally relied on the FTB's actions and representations. He also contends that this issue has already been decided in the taxpayer's favor in the Appeal of Henry J. and Florence Bradley, supra, where it was stated that the amount of gain recognized on the sale of small business stock acquired before September 17, 1981, "must be determined under the non-small-business-stock provisions of section 18162.5, subdivision (a)."

We agree with the taxpayer regarding this argument. Here again, the FTB has proceeded for a number of years without raising this issue and has, in fact, not only allowed but has itself used the capital gains provisions of subdivision (a) in situations such as this. We think that it has acted correctly in doing so and hold that it would be erroneous for FTB to apply the "Catch-22" rule they propound here. It seems to us to be perfectly reasonable to reconcile any arguable ambiguity here by applying the special small business rules for capital gains of subdivision (b) of section 18162.5 to small business stock acquired after September 16, 1981, as provided by subdivision (d) of the section, and applying the usual capital gain provisions of subdivision (a) to non-small-business stock and small business stock acquired before September 17, 1981. This has apparently been FTB's practice until very recently, when it saw that taxpayers might be getting a double benefit and it decided it could kill two benefits with one stone. Unlike the FTB, we are not offended by this situation, nor do we think that it violates the purpose of the Legislature in enacting the various small business stock provisions, whether or not this specific result was intended. Indeed, we believe that the FTB's solution to the apparent ambiguity in section 18162.5, which penalizes certain holders of small business stock, clearly violates the intent of the Legislature. Therefore, we reiterate our statement in the Bradley appeal, supra, that the amount of gain recognized on the sale of small business stock acquired before September 17, 1981, "must be determined under the non-small-business-stock provisions of section 18162.5, subdivision (a)."

For the reasons stated in the foregoing opinion, the action of the Franchise Tax Board in denying the appellants claim for refund must be reversed.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Brian L. and Phyllis Harvey for refund of personal income tax in the amount of $3,113,576.31 for the year 1986, be and the same is hereby reversed.

Done at Sacramento, California, this 23rd day of April, 1992, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, Mr. Fong, and Ms. Scott present.

Brad Sherman, Chairman

Ernest J. Dronenburg, Jr., Member

Matthew K. Fong, Member

Windie Scott*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

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